



ALIGNING INTERESTS

An effective investment partnership requires much more than adding the latest strategy to a portfolio.

BY MARTIN JACK

Are pension plans just naturally resistant to change, or is the investment management industry failing to communicate effectively? A recent study¹ asked both investment managers and pension fund sponsors which products were best suited to meet pension funding needs over the next five years. Investment managers listed in order of importance: liability driven investing (LDI), portable alpha, hedge funds, structured products and private equity. Plan sponsor responses were far different, reflecting more “old” products than new: global equities, emerging market equities, real estate, multimanager programs and private equity. Why the difference in emphasis?

In my experience, plan sponsors prefer to let their investment strategies evolve rather than make fundamental changes. Trend data reveals a gradual reduction in equity exposure along with movement toward more diversified, global strategies. Plan sponsors also are turning to multimanager programs, in part because of disappointing historical performance from active managers running individual mandates, but also as a means to gain exposure to hedge funds or private equity. There are, however, a number of inhibitors that will — at the very least — slow adoption of other strategies.

Plan Sponsor Considerations

Current accounting standards incent U.S. plan sponsors to maintain high exposures to risk assets. They are apparently prepared to take on the funding risk that is being ratcheted up by European regulators. Secondly, there is an understandable reluctance by corporate treasurers to take the reputational risk of putting in place an LDI strategy that locks in interest rates at relatively low levels.

Complexity and Transparency

The acceptance of strategies using derivatives will take time, as plan sponsors want to ensure they fully understand — and are

comfortable with — the supporting infrastructure. Similarly, a lack of transparency in many hedge fund strategies makes it difficult to get buy-in even after extensive client education.

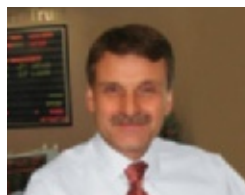
Too Much Choice

Plan sponsors recognize the need to update investment policies. Yet, with so many options among alternative asset classes and a lack of reliable extended performance history, allocation decisions are slow in coming. Many pension plans are taking a back-to-basics approach and revisiting their investment beliefs. This rethinking may be the root cause of the disconnect found in the research study cited previously.

I think ultimately we will see the widespread adoption of LDI and absolute-return strategies. However, this will take more time than the investment management industry would wish — or expect.

In the future, successful investment managers will be those with the skills to understand client needs and the ability to design appropriate open-architecture, custom-made solutions. They will be effective at assembling products and able to provide ongoing risk management support. And, they will have built the trust and confidence that they are focused on the client’s best interest, instead of rolling out new products for the sake of change. ♦

¹ Create-Research, “Tomorrow’s Products for Tomorrow’s Clients,” 2006



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Editor’s Note: Martin Jack joined Northern Trust after serving for the past decade as director of retirement funds for Europe, Middle East and Africa at a leading global information technology company. His experience and insights are helping shape new investment solutions for institutional investors.